

BISNIS Bulletin



Facilitating Commercial Success
in Eurasia

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Conducting Due Diligence in Russia

by Laura M. Brank

Over the last several years, many Russian companies have begun to recognize the value of transparent operations and sound corporate governance, making foreign investment in Russia and commercial relationships with Russian partners more attractive than in the past. At the same time, investors need to be cautious before moving forward in Russia.

Proper due diligence is critical for a number of reasons. First, it is important to know with whom and what you are dealing. Often times, there are multiple ownership levels in Russian companies, and true owners are hidden behind offshore entities. Second, a Russian company may have “hidden” liabilities such as sureties, guarantees, or other contingent liabilities that are not accounted for in the company’s books. Third, even if a proposed partner or acquisition target adheres to good corporate governance principles in Russia and is upfront about any possible legal violations, there still may be issues of concern to a U.S. investor that may not be at all apparent or problematic to a Russian company. Such issues often arise in connection with environmental, labor, tax, and currency matters.

What to Look for in Potential Transactions

Legal Status and Proper Establishment. The first order of business in any transaction is to determine the legal status of the Russian company with which you are seeking to do business. For example, if the shares of the company were originally issued through privatization of a state-owned enterprise, the privatization documents must be reviewed to ensure that the initial transaction conveying title to the purchaser complied with the tender/auction requirements.

Due diligence should ensure that the company’s charter complies with Russian law. Foreign investors should also confirm that the charter does not contain any restrictions on foreign ownership.

Proper issuance of shares of a Russian company generally requires shareholder approval and registration of the shares, typically with the local branch of the Federal Commission on the Securities Market. Additionally, any licenses issued with respect to certain industries (particularly those involved in the exploitation of natural resources) must be reviewed carefully to ensure that the company has the proper authority to carry out its activities. Licenses may also contain some restrictions on foreign ownership.

Ownership of Shares. In the case of an acquisition, to ensure that the shareholders have good title to the shares of the target company, due diligence should confirm that all necessary corporate actions—including

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Sixth Annual Conference

Georgian Crossroads: Politics, Economy, and Business
 America-Georgia Business Council
 in cooperation with
 Institute of International Studies, Stanford University

December 4–5, 2003
 Palo Alto, Calif.

Senior U.S. and Georgian government officials, business leaders, and experts of the region will discuss political-economic and business development strategies for Georgia. Areas of focus will include the sectors of energy, transportation, tourism, agribusiness, financial services, and new technologies.

For more information, visit www.agbdc.com or call 202-416-1606.

Useful Resources for Georgia

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www.usembassy.ge

Embassy of Georgia in the United States
www.georgiaemb.org

American Chamber of Commerce in Georgia
www.amcham.ge

America-Georgia Business Council
www.agbdc.com

ExpoGeorgia
www.expo.com.ge

BISNIS Online Georgia Page
www.bisnis.doc.gov/georgia

Funds World Russia

November 24–26, 2003
 Moscow, Russia

This event is for investors, fund managers, regulators, and the funds industry. Major topics to be addressed include reforms and developments in the Russian funds industry, corporate governance and shareholder activism, liability of funds, Russian custody services and fund administration, developments in the equity market and alternative investments, and product development and fund management best practices in Russia.

Contact: Olga Skachko at tel. + 44 (20) 7827 5977,
 email olga.skachko@terrapin.com, or visit
www.fundsmanagementworld.com/2003/funds_RU.

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Status of Credit Reporting in Russia

by Igor Yegorov

Many U.S. companies seeking to obtain reliable and accurate credit information about Russian companies and individuals will find that this not a simple undertaking, because there are no direct parallels to American credit bureaus or rating agencies. Finding and evaluating information on a potential business partner, not to mention credit history, can be extremely challenging. Many Russian companies are wary of providing information about their business, especially sensitive financial and credit data. Even if such information is available, it is usually submitted by the company itself rather than obtainable from open or independent sources, such as in business directories, on the Internet, or from private rating agencies or bureaus. The lack of publicly available credit history information complicates commercial activities and will continue to be problematic for U.S. companies evaluating Russian partners, customers, or investments for the foreseeable future. Although changes are under way that may ultimately ease the challenges of evaluating a prospective buyer or partner.

Current Status of Credit Reporting

In Russia, information on a borrower's credit history and paying habits is not yet a matter of open exchange between relevant parties. It is impossible to legally purchase a credit history of a company or an individual. There are almost no mechanisms for the legal and systematic accumulation of such data. Even when some information is available, there is no guarantee that it is accurate.

The sole source of official information about a company (if it's not an open joint-stock company) in Russia is the State Statistics Committee (Goskomstat). All companies are obligated to submit financial statements (upon approval of the tax authorities) to Goskomstat. However, Goskomstat is very slow in processing information. As a result, by the time the information is finally processed, it may no longer reflect the true state of the company. Moreover, some companies fail to submit reports to Goskomstat on a regular basis, particularly in a year that hasn't been successful. In any case, companies are not required to provide credit information to Goskomstat.

One result of this lack of information necessary for risk assessment is that banks are less willing to extend credit. This is particularly problematic for small and medium-sized companies, which either do not qualify for credit at all or cannot attract

credit on reasonable terms. Moreover, it means that businesses have to rely on personal ties, information provided by their partners (and thus not independently verified), informal channels, and other sources to take business decisions. This complicates the process, making it expensive, time-consuming, and less objective, narrowing the circle of potential partners, buyers, and suppliers.

Any Russian company that relies on banks for financing and most large Russian companies follow a set of strategies for disclosing information about their businesses in an effort to increase transparency. The strategies include the adoption of international accounting standards and corporate governance codes, hiring of independent directors, and so forth. By law, all open joint-stock companies are required to publish annual reports and submit certain information to Russia's Federal Commission for Securities and Markets. This information is available at <http://disclosure.fcsm.ru> (in Russian only).

Legislative Environment for Credit Reporting

Existing laws do not address the need for an up-to-date credit reporting system. However, recent signs indicate that Russian businesses are beginning to understand the need for and importance of greater transparency about their operations and finances and that the mentality of distrust (or only trust of known entities) is changing. According to Inna Danilchenko, project manager at **Dun & Bradstreet Nord** (St. Petersburg, Russia), the volume of orders for business information reports has increased significantly in the past three years, indicating a gradual change of business practices—that is from seeking information through formal instead of informal channels. However, the company under review still remains the most important source of information. If its management is unwilling to provide information, then there is no legal way to obtain it.

Various legislative initiatives are under way that would allow the effective functioning of credit information resources, including the discussion of draft laws on information of a personal nature, commercial secrets, professional secrets, and credit bureaus. However, when and which laws will be enacted remains an open question. Moreover, the draft laws only address issues of the establishment of consumer credit bureaus; commercial credit bureaus are not being actively discussed.

Two Initiatives to Provide Credit Info

An effort to create the first Russian private consumer credit bureau is being carried out by **Delta Capital Management** (www.deltacap.ru). This bureau may expand coverage at later stages to include commercial clients. According to Ms. Marlena Hurley, vice-president of Delta Capital, the bureau will be modeled after Western concepts, but take into account Russian

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DUE DILIGENCE *continued from page 1*

special approvals that may be necessary if the state owns a stake in the enterprise—have been taken. Almost all Russian shares are “uncertificated,” and ownership is recorded in book-entry form in the shareholder register.

If acquiring newly issued shares, investors should check whether the issuer’s charter grants existing shareholders preemptive rights to participate in the purchase of the shares. Closed joint-stock companies and LLCs always grant preemptive rights, and they may also grant rights of first refusal.

Corporate Governance Issues. Investors should also be familiar with the authority of each governing or management body within the Russian company in question to ensure proper signatory authority. The charter of the company and various internal regulations and powers of attorney should be carefully reviewed. It is not uncommon for a Russian party to subsequently argue that a given company official was not authorized to execute a particular agreement.

Ownership of Assets. If an investor is considering an asset acquisition (as well as certain large share purchases from the issuer), it is necessary to confirm that additional corporate approvals have been obtained. For example, any transaction involving assets in excess of 50 percent of the balance sheet value of a Russian company’s assets requires a qualified majority vote at a general meeting of shareholders. Transactions between the company and an “interested person” (including managers, directors, and shareholders with 20 percent stakes) must be submitted to the board of directors, the company’s audit committee, and the company’s auditor.

Real Estate and Other Property. All real property, including land, and any transactions involving real property or land, must be registered with an appropriate registering body, which in most cases will be the local registry for immovable property, in order to be valid. Therefore, where real estate is involved, most due diligence will involve reviewing title certificates, purchase contracts, leases, and mortgages to ensure that they have been registered and, for mortgages, notarized. It is also important to verify with the registering body whether any liens have been filed and to confirm that use of the real property is permitted, especially with regard to land use.

Tax Issues. With regard to taxes, all of the company’s tax filings should be reviewed, but it is also important to investigate any actions the tax authorities may have brought against the company and to verify the validity of any tax exemptions or audits on which the company may be relying. Finally, particular attention should be devoted to the company’s arrears to social funds, if any, as well as medical and education obligations.

**Seventh Annual
U.S.–Russian Investment Symposium:
Toward Diversification of the
Russian Economy**

November 12–14, 2003
Boston, Mass.

*Presented by Harvard University and Dow
Jones Conferences*

For more information, visit www.usris.org or contact Ms.
Marina Guitchounts at tel. (617) 495-3043 or email
marina_guitchounts@harvard.edu.

Liabilities. It may be very difficult to identify the many liabilities Russian companies potentially face. Where violations of environmental or labor regulations are identified, often only small penalties are applied, which can mask the true extent of a problem. Any existing court cases or documents concerning administrative proceedings against a target company should be carefully analyzed, with particular attention to documents related to the use of hazardous materials.

Contractual liabilities may also be a problematic issue. Particular attention should be paid to the legality and enforceability of real estate leases and joint activity and consulting agreements. If there has been any litigation against the company, investors may be unable to access court records to conduct their due diligence, since court records are generally not available to the public.

Labor Matters. Even though Russian labor is generally inexpensive, many remnants of the Communist labor system remain and thus a company’s labor structure should be carefully analyzed. Collective employment agreements may affect how the company operates, but even without a collective agreement there may be serious restrictions on the termination of employees. Also, there may be hidden payroll issues, including payment schemes that are not clearly reflected in the company’s books.

The due diligence process in Russia is never easy, but recognizing and resolving fundamental issues early on could save a great deal of time, expense, and headaches in the future.

*Laura Brank is the managing partner of the Moscow office of
Chadbourne & Parke, LLP (www.chadbourne.com).*

U.S.-Russian Negotiation Strategies

by *Natasha Crundwell*

Conducting negotiations in Russia can be complex and challenging. Russians are tough negotiators and require time to build trust, which tends to be reflected in the sometimes slow and grueling negotiating process. Russians often spend a long time working out a larger picture. Once the grand plan is in place, they move to specifics. Russian negotiators favor

the “chess” approach—several moves are planned ahead, which requires time and results in very little initial progress.

In contrast, Americans tend to move from specifics to a bigger picture, favoring a linear approach. The goal is to open with sequential moves to advance quickly in early stages and obtain tangible results. These key American-Russian differences in conceptualizing and planning negotiations are also reflected in the approaches to time and relationship-building during negotiating.

However, Russian businesspeople are becoming increasingly aware of Western negotiating style. More and more professionals are adjusting their expectations and tactics to match those of Americans and Western Europeans.

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Comparing Approaches

Americans' negotiating profile

“Time is money,” time is measurable, focus on immediate results, advance at the initial stage.

Comfortable doing business with strangers, based on “I am OK/You are OK” approach; defaulting to a sophisticated and reliable legal system in case a deal goes bad.

Pragmatic and practical approach to secure a win-win outcome in the shortest possible time and move on.

Compromise is a means to move a deal forward as an integral part of a “give and take” process.

Uncomfortable with silence. Comfortable with words.

Uncomfortable with stalling, impatient to get the deal done.

Outwardly friendly and businesslike communication style to establish instant rapport on a fairly informal basis.

Open with a position fairly close to the desired position, may open with a number of specifics to start moving forward.

Accept “no” at face value. Assume it is true when told something is non-negotiable and move on.

Avoid emotional displays, separating business and personal.

Russians' negotiating profile

“The slower you ride, the farther you get,” time is not valued or segmented in terms of money, need more time at the initial stage to gather intelligence, evaluate opponent, and probe for weaknesses to ensure rapid advance at the closing stage.

Suspicious of strangers and foreigners. Prefer to do business with people they know and trust due to a cultural preference for a more personal approach to conducting business. This preference is reinforced by a lack of, or “sporadic,” legal protection.

Traditionally view negotiations as a battlefield, with winner-takes-all approach; this approach is still prevalent although it is going through a deep transformation.

Compromise is a sign of weakness. The word itself has a negative connotation in Russian, meaning “being compromised.”

Excellent at maintaining long pauses, knowing this causes opponents discomfort.

Stalling and unresponsiveness may be used to exasperate goal-oriented opponents and gain concessions, or due to hidden agendas.

May use a combination of formality blended with a touch of hostility, replaced with cordiality the following moment to throw opponents off balance.

Always wait for the opponent to state initial position. Usually use a “tough opening” with a maximum demand.

Never accept “no” first time. Will modify their request and make it again and again.

Employ emotional displays, as business is personal.

NEGOTIATION STRATEGIES *continued from page 5*

Practical recommendations for successful negotiations

In light of the above differences in approaches, U.S. companies should consider the following recommendations when negotiating with Russian counterparts:

- Adopt a long-term approach and commit to invest time in relationship building.
- Be constantly on guard, even when you have secured a special relationship. It may place extra demands on you and you might find it difficult to maintain a strong negotiating position.
- Explain your business model to your Russian counterparts. Do not assume they are familiar with it.
- Ignore occasional attempts at intimidation.
- Ask a lot of probing questions.
- Become an active listener; observe non-verbal behavior.
- Maintain a firm and consistent position at all negotiating stages. However, draw a fine line between a firm position and a position of power: Never treat an opponent from a position of power or in a condescending way because he will walk out.
- Address directly and politely issues of “stalling” and “going-in-circles.”
- Learn to be comfortable with your Russian counterparts’ “strategic” delays. Do not show irritation or impatience.
- Avoid making quick concessions, particularly at the initial stages, your opponent will keep coming for more, and you won’t be able to provide it.
- Always bring your own interpreter, even if he/she sits there just listening and taking notes.
- Always have a contingency plan.
- Be prepared to start all over just when you think the deal is done. Negotiations are not complete until the money is in your bank.
- Be prepared to walk away from a deal if it does not meet your ethical or financial criteria.

Gaining awareness of your personal communication preferences and learning about Russian negotiating styles are essential to the success of a business venture. Understanding U.S.-Russian perspectives enables businesspeople to negotiate with confidence and gain an edge over the competition.

Natasha Crundwell is president of People Going Global, LLC, a Washington-based communications firm specializing in cross-cultural management training (www.peoplegoingglobal.com, email: natasha@peoplegoingglobal.com, tel. 703-931-8425).

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Retail Russia

October 29, 2003
Boston, Mass.

Organized by U.S.-Russia Chamber of Commerce of New England

First U.S. conference focused on retail opportunities in the Russian marketplace. Topics to be discussed include an overview of the burgeoning consumer sector in Russia today, analysis of existing and emerging distribution channels, and trademark and intellectual property protection. Attendees will include key Russian and American consumer industry executives.

For more information, visit www.usrccne.org.

STATUS OF CREDIT REPORTING continued from page 3

specifics. The bureau will unite several prominent banks with wide retail credit clientele bases. In the absence of a law that would allow banks to contribute data to the credit bureau, the banks will include a clause in credit agreements with customers that confidential information about a loan may be disclosed to the credit bureau. This information will be submitted to the database of the bureau, and every bank that has a contract would have access to the credit histories of their consumers. Since the information will be confidential, only authorized banks (those which signed contracts with the bureau) will be able to access consumer credit information. Initially, the database will mostly include Moscow-based consumers.

Dun & Bradstreet (www.dnb.ru) recently launched an initiative in Russia to collect credit information about companies on a voluntary basis, called the Creditors Club. Through such industrial creditors clubs, participants can share information on the fulfillment of credit contracts by their debtors. Companies that sign a participant agreement with D&B provide overdue payment data on their debtors on a monthly basis. This information is then compiled by D&B and placed in the system as aggregate debts of each debtor to the particular club (currently there are clubs of pharmaceutical and food creditors). The Web site www.creditnet.ru does not disclose the source of the information. Information collected through the industrial creditors clubs may later be used for the establishment of a national credit bureau of commercial clients (but not individuals).

For a more detailed report on credit reporting in Russia, visit www.bisnis.doc.gov/bisnis/bisdoc/0306Credreru.htm.

Igor Yegorov is the BISNIS representative in Northwest Russia.

BISNIS Interview: Pursuing Contracts on Sakhalin Island

BISNIS Bulletin talked to Paul Iremonger, general manager of Sakhalin Machinery Company (www.sakhalinmachinery.ru), which sells and services Caterpillar heavy machinery and generators in the Russian Far East, about its experience trying to win contracts related to the huge oil and gas projects taking place offshore Sakhalin Island.

How long has Sakhalin Machinery been operating on the island and what facilities does it have?

Sakhalin Machinery has been in existence for approximately two years. We started out as five employees in a small downtown office. Our dealership now has 59 workers in a three-story office building and at a 3,000-square-meter workshop in Yuzhno-Sakhalinsk.

What are some of the challenges you have faced in importing equipment and machinery to Sakhalin?

Our two biggest challenges are:

(1) Japanese competition. Geographically, Japanese manufacturers are right next to Sakhalin. Their delivery times for parts and machinery are much shorter than ours, since our equipment and parts come from much farther away. Also, Japanese companies have won many of the major contracts to supply services for the oil and gas projects, and they tend to buy machines from their own country.

(2) Finding, and retaining, qualified employees. Sakhalin Island is sparsely populated. Within this limited population, only a small percentage are English-speaking, computer literate, and have a strong work ethic. With dozens of Western companies on the island all looking for skilled people, demand is much higher than supply.

What has been your strategy for competing for contracts/procurement for Sakhalin oil and gas projects?

Besides typical advertising and use of an active sales force, Sakhalin Machinery's strategy has been to build strong service and parts departments. We believe that if we provide quick service, keeping machine downtime to a minimum, our market share of machines on Sakhalin Island will naturally increase.

What are some of the difficulties that you have encountered in winning contracts?

There has been little consistency in contract award methods. At times, "online bidding" systems are used, and price is the sole factor in awarding a contract, regardless of such factors as Russian content, local service availability, parts stocked on Sakhalin Island, etc. At other times, deals are concluded without a formal announcement calling for suppliers, which does not allow qualified potential bidders, including Sakhalin Machinery, a chance to participate.

Could you describe one or more useful approaches for doing business in the region?

We have found that creative financing is a fantastic sales tool. Fortunately, Sakhalin Machinery is a dealer for a company that believes in strong support of its dealer system. Besides the fact that Caterpillar, Inc., has two support offices in Russia (Moscow and Vladivostok), CAT Finance opened an office in Russia as well. CAT Finance offers creative financing schemes at favorable terms to its dealers and our customers. This means that 100-percent cash payment before a machine is delivered to a Russian customer is not necessarily the only option. The majority of our sales now involve some type of financing.

For more information on the Russian Far East, including Sakhalin Island, visit the BISNIS Web site at <http://bisnis.doc.gov/foreast.htm>.

To contact Paul Iremonger, call tel. +7 (4242) 46-21-81, fax +7 (4242) 72-83-86, or email pauliremonger@sakhalinmachinery.ru.

Sakhalin Oil and Gas 2003

November 17–20, 2003
London, United Kingdom

IBC's Seventh annual Sakhalin oil and gas conference is an internationally recognized industry event focusing specifically on the oil and gas developments on Sakhalin. The record attendance in 2002 included key decision-makers in the Russian Ministry of Finance, Sakhalin administration, and U.K. government, as well as operators, contractors, subcontractors, service support companies, and banks.

For more information, visit www.ibcenergy.com.

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UralStroyIndustry (Construction) Organizer: Web site:	November 11–14, 2003 UralExpoCenter, ITE Exhibitions www.uralexpo.mplik.ru	Yekaterinburg
Caspian Gas: Strategies for Development Organizer: Web site:	November 17–18, 2003 EuroForum www.ef-international.co.uk	Brussels
Strategies for Maximizing Profit in the Russian Financial Sector Organizer: Web site:	December 1–3, 2003 Adam Smith Conferences www.asi-conferences.com	London
Pulp & Paper Industry in Russia & CIS Organizer: Web site:	December 2–4, 2003 Adam Smith Conferences www.asi-conferences.com	St. Petersburg

Partnerships for Prosperity and Security: Accessing Innovative Technologies from Russia, Ukraine, and Kazakhstan

November 5–6, 2003
Philadelphia, Penn.

The conference, sponsored by the U.S. Department of Energy's National Nuclear Security Administration (www.nnsa.doe.gov) and produced by the United States Industry Coalition (www.usic.net) will include a number of distinguished government officials and industry leaders. The exhibition will feature 100 high-technology products ready for commercialization in the following areas: energy—nuclear fuel and reactor technology; energy—coal, petroleum, and gas; energy—fuel cells; detection technologies I—materials protection, control and accountability (nuclear, biological, chemical); detection technologies II—homeland security and counter-terrorism; aerospace; radio-pharmaceuticals; information technologies; nanotechnology; and general technology.

For more information, call (703) 243-9710,
e-mail info@partnershipsforprosperity.net,
or visit www.partnershipsforprosperity.net.